

**REGULAR STATE BANKING BOARD MEETING
HELD BY CONFERENCE CALL
OFFICE OF THE COMMISSIONER
DEPARTMENT OF FINANCIAL INSTITUTIONS
2000 SCHAFER STREET, SUITE G
BISMARCK, NORTH DAKOTA**

November 10, 2005

The regular meeting of the State Banking Board was held in the Office of the Commissioner, Department of Financial Institutions, 2000 Schafer Street, Suite G, Bismarck, North Dakota. Chairman Karsky called the meeting to order at 9:02 a.m., Thursday, November 10, 2005, by conference call.

MEMBERS PRESENT: Timothy J. Karsky, Chairman (*Office*)
Ron Braseth, Member (*Mayville*)
Bill Daniel, Member (*Office*)
Lorren Henke, Member (*Wishek*)
Launa Moldenhauer, Member (*Office*)
Roger Monson, Member (*Finley*)
Anita Quale, Member (*Watford City*)

MEMBERS ABSENT: None

ALSO PRESENT: Robert J. Entringer, Secretary (*Office*)
Doug Grenz, Chief Examiner – Banks (*Office*)
Robert Sorenson (*Office*)
Dana Ereth (*Office*)

APPROVAL OF MINUTES

Chairman Karsky indicated the Board received copies of the minutes of the regular meeting held on September 8, 2005. **It was moved by Member Moldenhauer and seconded by Member Braseth to approve the September 8, 2005, minutes as presented. The motion was unanimously carried.**

DAVIS BANCSHARES, INC., MCCLUSKY – CHANGE OF CONTROL APPLICATION

Assistant Commissioner Entringer noted the application was received on September 15, 2005, and deemed complete on September 22, 2005. The application was published pursuant to North Dakota Administrative Code Section 13-02-17-01 in the *McLean County Independent* on September 29, 2005. The comment period ended October 10, 2005, and no comments were received nor were there any requests for copies of the application. Assistant Commissioner Entringer's Memorandum outlined the approval criteria for the Board found in North Dakota Century Code Section 6-08-08.1(4). Assistant Commissioner Entringer noted the proposed acquisition will result in Davis Bancshares, Inc., acquiring 100% of Underwood Holding Company and the funding mechanism is discussed in Confidential Exhibit 9. Confidential Exhibit 8 includes the pro forma balance sheet for David Bancshares, Inc., and reflects the entries required for the transaction at the holding company level. Also, Confidential Exhibit 11, the pro forma balance sheet for First Security Bank, Underwood, details the impact to the bank as a result of the proposed transaction and notes the bank remains well-capitalized after the transaction. Confidential Exhibit 12 is the projection for the holding company; the projection notes the long term debt is expected to be eliminated by the year 2020. The projection for the holding company reflects an increasing equity position for the 12-year projection period and also is projecting positive income and the sources and uses of cash flow indicate adequate cash flow for the projection period. Assistant Commissioner Entringer noted the assumption used in all the projections appear to be reasonable. Exhibit 7 in the open section of the application shows the current and proposed directors and officers of Davis Bancshares, Inc., as well as the subsidiary banks. The changes in directors and officers for First Security Bank, Underwood, includes John E. Davis, Jr., added as Chairman of the Board; Robert Sorenson replaces David Kjelstrup as CEO/President/Director; Gerald Peerboom replaces Sara Jacobson as a Director; and Fred Meyers leaves the Board of Directors.

Assistant Commissioner Entringer noted it is the recommendation of the Department to approve the change of control application for Davis Bancshares, Inc., to acquire and merge Underwood Holding Company.

Chairman Karsky asked Mr. Ereth if he would like to review the application in more detail with the Board.

Mr. Ereth noted the application was filed with both the state and Federal Reserve on September 15, 2005, and they did receive a comment from the Federal Reserve on September 22, 2005. In the response from the Federal Reserve, Mr. Ereth indicated they did have some issues which he would like to discuss with the Board. The first item was the pro forma debt to equity which exceeds slightly one to one at consummation of the transaction, and Mr. Ereth indicated a couple of things were done including looking at the excess capital at First National Bank of McClusky, which would be available to reduce the debt of the holding company. Mr. Ereth noted in the application there is a hypothetical dividend which was used by the applicant to show that in effect they could use the excess capital. The second item was that the Federal Reserve has a policy for small bank holding companies when the debt exceeds one to one debt to equity; they do not want dividends coming out of the holding company. Mr. Ereth pointed out if they would use the excess capital of First National Bank of McClusky by drawing the capital down to 8%, the debt to equity could be approximately .66 to 1; however, the Davis Bancshares, Inc., Board did make a commitment to the Federal Reserve that any dividends paid out would not be paid out until the debt to equity at the holding company is less than 1 to 1. The last item raised by the Federal Reserve was what is deemed confidential and was it not. The applicant took the approach that everything that is a legal document should be accorded confidential treatment. Mr. Ereth noted the Federal Reserve required some of the more generic documents to be placed into the open section of the application which was done.

Mr. Ereth noted the applicant had received a letter dated October 20, 2005, approving the application with no conditions. Mr. Ereth reviewed the logistics of the transaction whereby David Bancshares, Inc., is purchasing 100% of the common stock of Underwood Holding Company and immediately merging Underwood Holding Company into Davis Bancshares, Inc. Davis Bancshares, Inc., will be operating two subsidiary banks. Mr. Ereth noted both the subsidiary banks will remain well capitalized throughout the projection period with the First National Bank of McClusky declaring a dividend of 100% of its taxable income throughout the projection period. Since both banks are Subchapter S the projections will actually show the capital decreasing in the national bank. Mr. Ereth did note that the equity of the holding company is increasing throughout the projection period. Both subsidiary banks have either satisfactory or outstanding ratings for CRA, and the acquisition seems to be a natural fit for both banks. The applicant only sees a benefit to the customer base for this acquisition. Mr. Ereth indicated both banks are located in the same banking market and, therefore, they did have to look at the competitive criteria, and the banking market includes

Bismarck-Mandan and so as a percentage of market share the bank will be at less than 2%. The HHI index did not come into play because the Bismarck-Mandan banking market is not a concentrated market, even though the increase in the HHI index is less than 2 points.

Mr. Ereth indicated the projections are based strictly on what both banks have been able to achieve over the last five years; there are no efficiency assumptions included in the projections although the applicant feels the financial performance in Underwood will be quite a bit better than what it has been historically. The improvement is expected to come primarily from the resignation of two Board members and the elimination of their salaries.

Chairman Karsky commented that the Department did look at the issue of dividends and puts more weight on the fact that the bank could have taken a larger dividend to reduce the debt at the holding company. The Department's perspective is that down the road if the bank runs into asset quality problems, we can restrict the dividend payments to the holding company and control the payments from that perspective. So, even though the Department did not comment on the debt to equity ratio, we certainly did take that into consideration.

Chairman Karsky indicated it is his understanding the banks will remain separate at least in the near term, and that he had just recently taken a call from a banker indicating the increase in the legal lending limit has helped this small rural bank tremendously and that other changes to help reduce regulatory burden have been beneficial for the small rural banks in North Dakota.

Member Moldenhauer asked about changes in staffing and hours at the First Security Bank, Underwood. Mr. Sorenson indicated that Dave Kjelstrup will leave the bank and Sara Jacobson will retire from the bank also. Mr. Sorenson indicated Ms. Jacobson's title was Vice President, but those are the only cuts made at the bank, and indicated he would be spending approximately half his time at the Underwood bank. Mr. Sorenson continued they are going to begin check imaging at Underwood, as the McClusky bank has been imaging checks for approximately 5 years, and plan to put in a T1 line to the Underwood bank in order to start processing the work through the McClusky computer system. Mr. Sorenson indicated they would like to blend the services of both banks, citing as an example that the Underwood bank does IRAs while the McClusky bank does not; the McClusky Bank images while the Underwood Bank does not.

Chairman Karsky asked about participations between the two banks, and Mr. Sorenson indicated they have done a few but when the merger is accomplished obviously they will no longer have any participations.

Mr. Ereth made a final comment regarding questions that Eide Bailly has been receiving relative to the Federal Reserve's proposed small bank holding company statement, particularly with the use of trust preferred securities. Mr. Ereth stated what the Federal Reserve is proposing is actually what they are already doing and this application is indicative of that. Because this application included a debt to equity ratio of 1 to 1, and because trust preferred securities are debt they are treating it as such. The Fed's stance is the trust preferred securities are treated as debt for the 1 to 1 ratio, so what is actually being put in the proposal is simply formalizing their current position. Mr. Ereth indicated it is obviously a benefit to expand the definition of a small bank holding company from \$150 million to \$500 million, but the Fed's determination that they would say 25% of trust preferred securities would be deducted so to speak from what they are considering debt for purposes of calculation of the 1 to 1 ratio. Mr. Ereth continued that is not their formal position now, but it is on a case by case basis; therefore, if they put that into the proposal it would be a benefit to our small banks. Mr. Ereth added there is another issue for anyone considering a transaction such as this that came out in a statement of position from the accounting professionals whereby you need to eliminate the allowance for loan losses in a business combination. If you have a bank and you want to draw the capital down to 8% to sell the bank and if you are relying on the allowance to keep the total risk based capital above 10%, because of this statement of position you would not be able to use the allowance in your total risk based capital calculation because you have to eliminate the allowance. Mr. Ereth indicated in this case it was not a big issue since Underwood is not that loaned up and there was abundant Tier One capital to keep the total risk based capital ratio above 10%.

It was moved by Member Moldenhauer, seconded by Member Monson, and unanimously carried to approve the application by Davis Bancshares, Inc., to acquire and merge Underwood Holding Company, Underwood.

ITEMS TO BE NOTED

Comptroller of the Currency

Effective 10-1-04, Bremer Bank, National Association, Fargo, closed branch at 801 5th Ave S, Devils Lake.

Effective 9-2-05, Bremer Bank, National Association, Grand Forks, closed branch at 102 E McKinley Ave, Shelly, MN.

Approved 10-18-05, Alerus Financial, National Association, to open branch at 4201 45th St S, Fargo, ND.

DISCUSSION ITEM

Chairman Karsky indicated approximately one year ago the Department sent out proposed rules for public comment on deposit production offices. The hearing was held and we had an additional 30 day comment period, and then tabled those deposit production office rules. Chairman Karsky indicated another situation has arisen and he would like the Board to reconsider the ability of state-chartered banks to have deposit production offices in the state. If the rules are approved, it would allow deposit production offices in another state. Chairman Karsky asked the Board to remember that a national bank right now could put a deposit production office anywhere in the state, whether the national bank was in North Dakota or not. Also, a state-chartered bank outside of North Dakota, if they have a wild card statute that says a state-chartered bank can do anything a national bank can do, would be allowed to put a deposit production office in the state.

Chairman Karsky questioned why we would want to restrict North Dakota state-chartered banks from being able to do this type of activity; therefore, he would like to bring this back before the Board. Chairman Karsky stated he did speak with Assistant Attorney General Miller as to whether or not we would have to go through the whole procedure again, and Assistant Attorney General Miller stated this has probably not come up before and we could certainly go through it as it would not cost any additional money. If we would act on the comments at the next meeting or hold a special meeting and approve those regulations and then submit them to the Attorney General for review.

Member Moldenhauer indicated she agreed with Chairman Karsky.

Chairman Karsky indicated we did receive some comments from the North Dakota Bankers Association, the Independent Community Banks of North Dakota, as well as Jim Goetz from Security First Bank of North Dakota, New Salem. Chairman Karsky stated if the Board was going to act on this, he would send those associations/individuals a letter telling them the Board is now going to act on these rules and ask if they want to submit any additional comments or review their previous comments with the Board again.

Assistant Commissioner Entringer indicated when these rules were tabled he had spoken to John Walstad with the Legislative Council, who indicated as far as Legislative Council is concerned the rules are still out there as a proposed rule and we did not have to withdraw, adding he did not believe the Department would have to republish.

Chairman Karsky indicated he would like some guidance from the Board as to whether they agree these rules should be brought back or leave this alone.

Member Monson stated as he recalls some of the concerns were that these rules might threaten deposits in small towns, adding if he understands this correctly, this would put state-chartered banks at a level playing field with national banks to go out of state.

Chairman Karsky stated not only out of state, but in state banks also, citing as an example the national bank in Belfield that is going into LaMoure with a branch. The Belfield national bank put a LPO in LaMoure and they did not have to notify anybody at the state level or any other bank in the area; and quite possibly also put a deposit production office in LaMoure also until they got the branch approved.

Chairman Karsky reminded the Board the activities you can do at a deposit production office are fairly limited and because of that he does not see someone coming in and taking deposits out of a small town or county. Chairman Karsky indicated what the Department is looking at now would at least allow the bank the ability to hand out information on deposits and set up the account, but then these individuals would have to bank by mail back to the main bank.

Chairman Karsky indicated it is his opinion that an out of state state-chartered bank or a national bank can do this, adding why would you want to penalize your own banks in North Dakota.

Member Henke said it sounds like the old paying and receiving station; however, Chairman Karsky indicated it is not because at a paying and receiving station you could take the deposits, whereas at a deposit production office you cannot.

Chairman Karsky added that a LPO can only do limited amounts of things, one of which is that they cannot close a loan at the LPO, and to his knowledge most of that is done at title companies.

Assistant Commissioner Entringer noted a customer could give a envelope with a deposit in it to be mailed to an individual at a deposit production office, but it is not accepted as a deposit at that time, it is only accepted as a deposit once it is posted, which would be when it is received by the North Dakota office.

Chairman Karsky feels he did not do a good enough job of explaining deposit production offices initially and how it disadvantages the state banks in North Dakota, and that out of state banks can already do this.

Chairman Karsky indicated he wants to bring these rules back to the Board for final action.

Member Henke moved, Member Monson seconded, and it was unanimously carried that the Board place the deposit production office rules on the agenda of the Board's next regularly scheduled meeting.

MEETING DATES FOR 2006

The meeting dates for 2006 were set for January 12, March 2, May 11, July 13, September 7, and November 9.

Dana Ereth and Robert Sorenson left the meeting at 9:40 a.m.

The Board went into closed session at 9:45 a.m.

Timothy J. Karsky, Chairman

Robert J. Entringer, Secretary